7 Adjusting Accounts for Financial Statements

LEARNING OUTCOMES

After reading this chapter, you should be able to:

- record the trial balance in a worksheet
- prepare adjusting entries at the end of a period
- prepare an adjusted trial balance
- complete the income statement and balance sheet portions of a worksheet

Once the trial balance is prepared, the next step in the accounting cycle is to prepare a worksheet on which required adjustments are made before financial statements can be prepared. In this chapter you will learn how to prepare a **worksheet**, adjusting entries, and an **adjusted trial balance**. You will also use this information to complete the financial statements portion of the worksheet.

Figure 7.1 highlights these next steps in the accounting cycle.

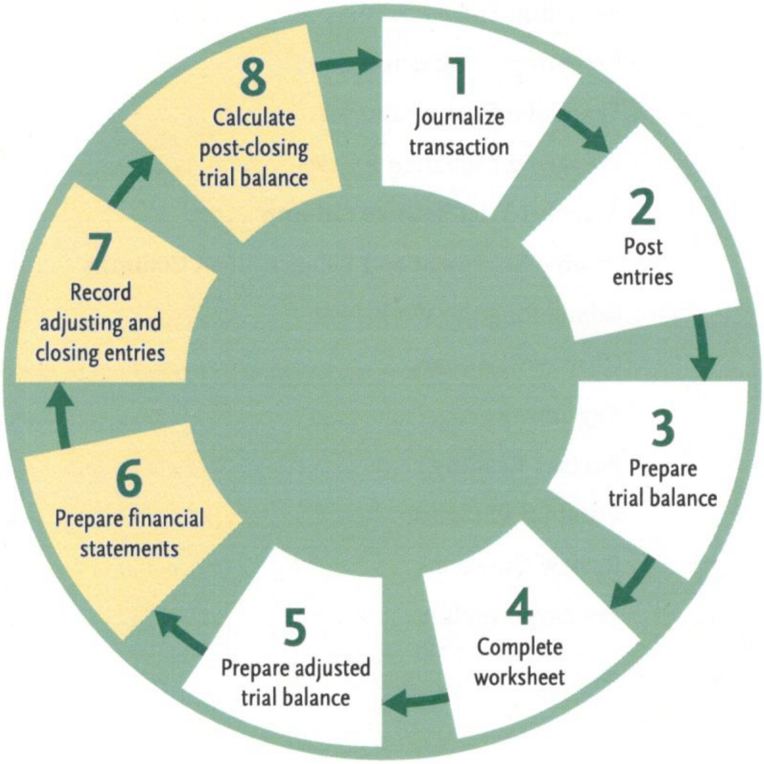

FIGURE 7.1 Steps in the accounting cycle

Adjusting Entries

At the end of the fiscal year, the firm is required to prepare an accurate and detailed statement of its revenues and expenses for income tax purposes. This is called an income statement and is used to calculate the profit (or loss) for the year. If the firm is a sole proprietorship, the business owner will have to include the amount of the profit on his or her personal income tax

return. A worksheet enables the accountant to organize and check data, and make any necessary adjustments, before financial statements are prepared.

Before preparing his personal income tax return, Justin Case will want to ensure his records have been maintained in accordance with Canadian generally accepted accounting principles (GAAP). In particular, he will want to make certain that the **matching principle** has been respected, that is, that expenses incurred during the current accounting period are related to or have contributed toward the revenue that was generated during the same period. This principle is fundamental to the **accrual basis of accounting**.

Justin does not want to pay more income tax than he has to, so the statements will be reviewed and the entries adjusted with a view to ensuring that the numbers are accurate and that all expenses and deductions he is entitled to claim have been recorded. The reverse is also true: when reporting income for tax purposes, Justin must not understate his profit as a result of income or expenses not being recorded in the correct period.

The adjustment process will include the following steps:

- Completing an accurate **office supplies inventory** and writing off supplies used as an expense
- Calculating capital cost allowance or depreciation on Justin's assets and recording the amount of depreciation as an expense
- Reviewing his accounts receivable to determine whether there are any bad debts to be written off
- Reviewing the accuracy of his liabilities and making any necessary corrections
- Ensuring there are no revenues and expenses that are to be carried over to the next operating year
- Preparing an adjusted trial balance

Preparing a Worksheet

The worksheet consolidates all adjustments to a firm's revenues and expenses. If the worksheet is prepared by hand, it can be completed in pencil because it is not a permanent record. Once the worksheet has been completed, the adjusting entries will be entered in the books of the firm using the general journal, and these entries will be posted to each of the ledger accounts affected.

The worksheet enables the bookkeeper to make sure that the books are balanced at each stage up to completion of the financial statements before starting the accounting cycle over again for the next period. A worksheet includes the following six column headings, as shown in Figure 7.2:

	Account Titles	Trial Balance		Adjustments				Adjusted Trial Balance		Income Statement		Balance Sheet	
		Dr.	Cr.		Dr.		Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.

FIGURE 7.2 Typical worksheet headings

1. *Account Titles:* The account numbers and names in the far left column of the worksheet are taken from the general ledger. The account number is not a requirement, but can be included if the bookkeeper finds it helpful. For the purposes of this chapter, account numbers are included.

2. *Trial Balance:* This section contains a list of all the accounts in the same order as they are found in the general ledger. Accounts with a zero balance are not listed. Additional account titles from the ledger will be added as they are needed once we start making adjustments.
3. *Adjustments:* Each amount in the trial balance must be reviewed by the business owner, bookkeeper, or accountant to determine whether any adjustments are required. An adjusting entry can be recorded at the end of each accounting period, for example, each month. Some business owners may be satisfied with doing adjusting entries annually at the end of the fiscal year. Others may want to do them more often. Once the adjustments have been made, the debit and credit columns must be totalled to ensure that the debits are equal to the credits. The entries in the Adjustments column are assigned a letter for reference purposes, giving the corresponding debit and credit entries for a particular adjustment the same letter. This is helpful in tracking the entries that were made if you are looking for errors.
4. *Adjusted Trial Balance:* After the adjusting entries are recorded in the worksheet, the balance in each account is recalculated to arrive at the new balance for each account, and the amount is placed in the Adjusted Trial Balance column. Amounts from the trial balance that have not been adjusted are simply carried over to the Adjusted Trial Balance column. If there was an adjustment made to an account, a calculation of the new balance must be done. Debits are added to debits, credits are added to credits, and debits and credits are subtracted from one another. Once the horizontal calculations have been completed, the debit and credit column totals of the Adjusted Trial Balance column must be equal.
5. *Income Statement:* Extend the amounts for the income and expense accounts from the Adjusted Trial Balance column to the Income Statement column of the worksheet. These are the accounts with the numbers 400 to 599. Be careful to enter the amounts in the correct column for debit and credit. Revenue will normally be in the credit column, whereas expenses will normally be in the debit column. The difference between the income (credit) column and the expense (debit) column is the profit or loss for the period.
6. *Balance Sheet:* Extend the amounts of assets, liabilities, and owner's equity from the Adjusted Trial Balance column to the Balance Sheet column. The asset accounts are the accounts starting with the numbers 100 to 199, the liabilities are the accounts starting with the numbers 200 to 299, and the owner's equity accounts start with the numbers 300 to 399. Total the debit and credit columns once the entries have been copied from the Adjusted Trial Balance column. These totals will not be equal. The amount calculated as profit or loss from the income statement will be used to balance the debit and credit columns in the Balance Sheet column in the bottom portion of the worksheet.

Types of Adjusting Entries

The common types of adjustments include:

- Prepaid expenses
- Amortization or depreciation
- Work in progress (WIP)
- Accrued expenses
- **Accrued revenues**

Prepaid Expenses

Prepaid expenses are sometimes referred to as unexpired expenses. They represent items that have been paid for in advance. As the asset is used the cost becomes an expense, and the amount used must be shifted from the balance in the asset account to the expense section of the ledger. Common examples of prepaid expenses are prepaid insurance, office supplies and other assets, and prepaid rent.

Amortization or Depreciation

Amortization or **depreciation** refers to the amount of wear and tear of an asset for which a reduction is made over time in the valuation of that asset. The diminished value will be shown on the firm's balance sheet. The amount claimed for depreciation is an expense. Assets such as computers and office furniture have a certain life and are expected to be used by the firm for more than one accounting period. They cannot totally be written off as expenses in the year they are purchased. The cost of the item will be written off as an expense over the estimated useful life of the asset. For income tax purposes, the amount expensed is called **capital cost allowance (CCA)**. When amortization expense is recorded it is considered an operating expense, even though no cash is actually spent. (The cash was spent when the asset was acquired.)

There are some terms with which you need to be familiar when discussing depreciation:

- **Historical cost** refers to the original price paid for an item.
- **Class** refers to assets included in a particular account. For example, the account for office furniture will include desks, chairs, waiting room furniture, and so on.
- **Accumulated depreciation** refers to the total amount that has been written off as an expense against a particular asset over time.
- **Book value** is the historical cost of the asset minus the accumulated depreciation. The number will decrease from period to period if no new assets have been added to the class.
- **Residual value** refers to the estimated value of the asset at the end of its useful life.
- **Contra-asset account** is an account in the chart of accounts that is linked to an asset account, such as Office Furniture and Equipment, and has a normal credit balance on the asset side of the balance sheet. In the case of accumulated depreciation, this contra-asset account records the depreciation of an asset. This account totals the amount of depreciation taken from time to time and is used to reduce the value of the asset on the balance sheet.

Depreciation will affect both the balance sheet and the income statement. The value of the asset on the balance sheet is being reduced by the amount of amortization taken. The expenses of the firm on the income statement are increased by the depreciation expense taken, resulting in lower income for the firm.

EXAMPLE 1

Depreciation

Suppose Justin Case purchased a photocopier costing $10,000 and took $79.17 depreciation in the month of December. The asset account would appear as follows on the balance sheet:

	Historical cost	
Assets		
Office equipment	10,000.00 (Dr.)	
Less: Accumulated depreciation on equipment	79.17 (Cr.) →	9,920.83 (Dr.)
	Accumulated depreciation (contra-asset account)	Book value

FIGURE 7.3 Depreciation of an asset

The amount of $79.17 will be posted as a debit to depreciation expense to balance the entry.

The value of the office equipment account shows the original cost of the photocopier. However, the accumulated depreciation for the period is linked to the office equipment account and the depreciation is subtracted (or credited) against the value. Once it is credited, the amount $9,920.83 represents the book value of the asset. You know how much was originally paid for the photocopier because the historical cost does not change on the balance sheet. Amortization will increase from period to period, reducing the book value of the asset as time goes by.

Calculating Amortization

To depreciate an asset, you have to calculate how much of its cost is used up each period. The Canada Revenue Agency (CRA) has specific rules that tell businesses in Canada how they can depreciate their assets for tax purposes. It is not necessary to use this calculation for financial reports because the value allowed by the CRA may be different from what the business owner feels is the useful life of an asset.

For the purposes of this textbook, we will discuss two methods of calculating amortization on assets, but we will use the straight-line amortization method for doing adjusting entries.

Straight-Line Amortization Method

The **straight-line amortization method** depreciates the value of an asset over its useful life after deducting its residual value, which refers to the estimated value of the asset at the end of its useful life. The amount of depreciation remains constant for each period.

The following formula is used to calculate the rate of amortization using the straight-line method:

$$\text{Depreciation} = \frac{\text{Cost of Equipment} - \text{Residual Value}}{\text{Estimated Useful Life}}$$

EXAMPLE 2

Suppose Justin purchased a photocopier that cost $10,000 and it was expected to last 10 years, at which time he expected the residual value would be $500. The calculation of depreciation would be as follows:

$$\frac{\$10{,}000 - \$500}{10 \text{ years}} = \frac{\$9{,}500}{10 \text{ years}} = \$950 \text{ per year or } \$79.17 \text{ per month } (\$950/12)$$

The photocopier is depreciating at a constant rate of $950 per year or $79.17 per month ($950/12 months). Using the straight-line method for calculating depreciation on Justin's photocopier, the book value at the end of four years would be $6,200:

Office Equipment	Life	Historical Cost	Residual Value	Year	Depreciation 9,500/10 yrs.	Accumulated Depreciation	Book Value
Photocopier	10	10,000	500	1	950	950	9,050
		10,000	500	2	950	1,900	8,100
		10,000	500	3	950	2,850	7,150
		10,000	500	4	950	3,800	6,200

FIGURE 7.4 Calculation of depreciation using the straight-line method

Declining Balance Amortization Method

The Canada Revenue Agency requires a business to calculate capital cost allowance using the declining balance method.[1] This means you claim CCA on the capital cost (original cost) of the property minus the CCA you claimed in previous years, if any. The remaining balance—the **undepreciated capital cost (UCC)**—declines over the years as you claim CCA.

The CCA that a business can claim depends on the type of property being depreciated and the date it was acquired. Classes of assets are set out by the CRA and assigned a specific rate of depreciation. For example, class 1 includes most buildings acquired after 1987 (unless they specifically belong in another class), and they can be depreciated at a rate of 4 percent. Furniture and appliances are categorized as class 8 and can be depreciated at a rate of 20 percent. If you claim CCA, and you later dispose of the property, you may have to add an amount to your income as a recapture of CCA. Alternatively, you may be able to deduct an additional amount from your income as a terminal loss. You are not required to claim the maximum amount of CCA in any given year. You can claim any amount you like, from zero to the maximum allowed for the year.

1 Canada Revenue Agency, "Claiming Capital Cost Allowance (CCA)," online: <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/menu-eng.html>.

EXAMPLE 3

Using the declining balance method for calculating depreciation on Justin's photocopier, the calculation would be:

Item	Class	%	Year	Cost	Capital Cost Allowance (CCA)	Undepreciated Capital Cost (UCC)
Photocopier	8	20%	1	10,000	1,000*	9,000
UCC x 20%			2		1,800	7,200
UCC x 20%			3		1,440	5,760
UCC x 20%			4		1,152	4,608
Total CCA					5,392	

FIGURE 7.5 CCA calculation using the declining balance method

* In the year you acquire property, you can usually claim CCA on only half of your net additions to a class, so the amount is calculated on $5,000 instead of $10,000. In this instance, only half of the CCA of $2,000 is allowed in the first year. If the business has operated for less than one year, the amount should be prorated. If Justin claimed CCA in his first year of business and he acquired the photocopier on December 1, he could claim $1,000/365 x 31 days or $84.93 as capital cost allowance.

Work in Progress

Work in progress (WIP) refers to services that have not been completed or that have been performed in part but are still in progress and, therefore, not yet included as earned income or revenue. As mentioned in Chapter 2, paralegals do not have the opportunity to exclude the value of work in progress from their income as is allowed for lawyers and accountants. An adjustment might be required to include as revenue the value of work in progress that has not yet been billed in income for the period. Usually, invoices are recorded when they are sent out and are shown as income. However, work in progress is recorded only when the invoice is sent. The **revenue recognition principle** of GAAP and the CRA rules governing paralegals require paralegals to include the value of work done on a file that has not yet been billed as revenue for the period. The balance sheet would also show the value of this work as an account receivable.

Accrued Expenses

Accrued expenses refer to costs incurred in a period that are both unpaid and unrecorded. For example, a business could have **accrued interest expense** owing on an unpaid account. Salaries often must be adjusted because the employee may be owed a certain number of days' pay at the end of the period, but payday is in the next period. Accrued vacation pay is a debt owing to the employee for which an adjustment may be required.

Accrued Revenues

Accrued revenues refer to income that has been earned but has not yet been recorded. For example, **accrued interest revenue** on an investment may have accumulated over the period, but may not have been received and not have been recorded in the records of the business. If Justin Case had a guaranteed investment certificate of $10,000 invested at the rate of 2 percent per annum, the daily interest accruing on the investment would be $10,000 × 2 percent per annum/365 days, or 55 cents a day. If he held the investment for 90 days, the adjustment would be $49.50.

Value of Work in Progress

TAX TIP

One of the adjustments you will be required to calculate for income tax purposes is the value of WIP if it has not already been included. The income statement you prepare for the purposes of filing an income tax return must include all fees you receive for goods or services you provide, whether you receive or will receive money. As a professional, your income generally includes the value of your work in progress. Your professional fees for the current year are the total of

- all amounts you received during the year for professional services, whether you provided the services before or during the current year or after your current year-end; plus
- all amounts receivable at the end of the current year for professional services you provided during the current year; and
- the value of your WIP at the end of your current year for which you have not received any amount during the year; minus
- all amounts receivable at the end of your previous year-end; and
- the value of your WIP that was included.

Preparing Adjusting Entries

Justin Case selected December 31 as his fiscal year-end. Once the accounting entries were completed, he prepared the trial balance as of December 31, and the balances were entered in the Trial Balance column of the completed worksheet in Figure 7.9 at the end of the chapter.

Adjusting Entries for Year-End

Upon reviewing the trial balance for his books at the end of December (Figure 7.6), Justin realizes that some transactions need to be adjusted before the financial statements for the year can be finalized. Each type of **adjusting entry** is demonstrated using the accounts described below.

Remember that even when doing adjusting entries, you must have a debit and a credit entry for the books to remain balanced. Each adjustment is identified with a letter of the alphabet (a, b, c, d, e, and so on) to track the corresponding debit and credit. Once you complete an adjustment, you must total the columns across the page to calculate the new balance in each account. This calculated amount is placed in the Adjusted Trial Balance column, as shown in Figure 7.7.

Justin Case, Paralegal Worksheet for the Month Ended December 31, 20**			
		Trial Balance	
	Account Titles	Dr.	Cr.
100	General Bank Account	$4,906.91	
115	Trust Bank Account	15,280.00	
120	Accounts Receivable	25,000.00	
125	Prepaid Insurance	600.00	
130	Office Supplies	630.00	
155	Computer Equipment (Hardware)	6,520.00	
158	Office Furniture and Equipment	2,250.00	
200	Accounts Payable/General Liabilities		$6,890.00
205	Personal Loan		3,000.00
210	Credit Card Debt		2,500.00
215	Trust Funds Owed		15,280.00
300	Justin Case, Capital		2,550.00
350	Justin Case, Drawings	1,800.00	
400	Fees Earned		31,580.00
511	Salaries Expense	960.00	
533	Meals and Entertainment Expense	350.00	
534	Membership/Professional Dues	1,343.75	
535	Office Supplies/General Expense	580.00	
538	Rent Expense	1,100.00	
565	Telephone Expense	479.34	—
	Total	$61,800.00	$61,800.00

FIGURE 7.6 Trial balance at December 31

Adjustment a: Prepaid Expenses

Justin has prepaid insurance of $600 on the trial balance. The insurance premiums cover one year; the policy starts on December 1 of this year and expires on November 30 next year. He must allocate the cost of the insurance over a 12-month period and cannot take the whole expense this year. This insurance covers liability for fire and theft on his premises.

The adjustment is calculated as follows:

$600 per 12 months = $50 per month

Justin must expense $50 for the month of December and leave the rest of the insurance premium in the prepaid insurance account. The adjusting entry required is a credit of $50 to the prepaid insurance account and a debit to the insurance expense account for $50.

The steps followed to enter this adjustment in the worksheet are as follows (and are shown in Figure 7.7):

1. Enter $50 in the credit column of prepaid insurance and place the letter (a) next to the entry.
2. The account named Insurance Expense (#527) is not listed in the trial balance. You must add the name at the end of the list in the Account Titles column.
3. Enter the expense of $50 as a debit in the Adjustments column. Place the letter (a) next to the entry in the space provided.
4. Calculate the new account balance, taking the adjustments into consideration. The adjusted balance for prepaid insurance is $600 – $50, or $550. The insurance expense account has a new balance of $50. Calculate the new balances and place them in the Adjusted Trial Balance column in the correct column for debit or credit.

Adjustment b: Office Supplies

Justin did an inventory of the supplies he has on hand in his supply cupboard. The amount remaining on December 31 is worth $200. His trial balance shows a value of $630 in the office supplies account.

Calculation of the adjustment:

Inventory shown in trial balance	$630
Less: Amount left in stock	$200
Amount used over the period	$430

The goal of this adjustment is to show the correct value of what is left as an asset, which is $200, and to record the amount of $430 that was used as an expense.

Justin must record the amount of $430 as an expense, and he has to credit the asset account Office Supplies (#130) to reduce the amount of the asset.

The adjusting entry required is as follows:

535	Office Supplies/General Expense	Dr.	$430
130	Office Supplies	Cr.	$430

The steps followed to enter this adjustment in the worksheet are as follows, and are shown in the completed worksheet in Figure 7.9 at the end of the chapter:

1. Enter $430 in the credit column of the asset account Office Supplies (#130) and place the letter (b) next to the entry.
2. The account Office Supplies/General Expense (#535) is listed in the Account Titles column, so it does not have to be added for this entry. Enter the expense of $430 as a debit in the Adjustments column. Place the letter (b) next to the entry in the space provided.
3. Calculate the new account balances after making the adjustments. The adjusted balance for Office Supplies (#130) is $630 less the credit of $430, or $200. The adjusted balance for Office Supplies/General Expense (#535) is $580 plus $430, or $1,010.

Account Titles		Trial Balance Dr.	Trial Balance Cr.		Adjustments Dr.		Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Calculating the Balances in the Adjusted Trial Balance
100	General Bank Account	4,906.91						4,906.91		When there is no adjustment, simply place the trial balance amount in the Adjusted Trial Balance column, respecting Dr. and Cr.
125	Prepaid Insurance	600.00				a	50.00	550.00		Place the letter identifying the transaction in the column provided. Each transaction will have the same letter in two locations, one for the debit (see account 527 below) and one for the credit. Calculate the new balance: $600 Dr. – $50 Cr. = $550. Place the difference of $550 in the debit column because the balance is a debit.
200	Accounts Payable		6,890.00			d			6,890.00	If the trial balance has a credit balance, and there are no adjustments, enter the amount in the credit column of the Adjusted Trial Balance column.
205	Personal Loan		3,000.00				100.00		3,100.00	If the trial balance has a credit balance and the adjustment is a credit, add the two credits together to obtain the new balance.
511	Salaries Expense	960.00		e	240.00			1,200.00		Add both debits together to get the new amount for salaries expense and place the total in the debit column of the Adjusted Trial Balance column.
	Total	61,800.00	61,800.00		Leave this space blank					Totals for the trial balance must be equal.
527	Insurance Expense			a	50.00			50.00		For the new accounts added at the end of the trial balance, the balance will be the amount entered in the Adjustments column. Place the amount in the Adjustment Trial Balance column, respecting Dr. and Cr. This is the entry that corresponds to entry "a" above.
	Totals				1,146.01		1,146.01	62,466.01	62,466.01	Total Dr. and Cr. for adjusting entries must be equal. Total Dr. and Cr. for the adjusted trial balance must be equal.

FIGURE 7.7 Extending balances to the adjusted trial balance

Adjustment c: Depreciation

The account for Computer Equipment (Hardware) (#155) has a value of $6,520 in the trial balance. Justin believes the assets have a useful life of about five years and that there will be no residual value for this equipment.

Calculation of depreciation using the straight-line method:

$$\frac{\text{Cost of Equipment} - \text{Residual Value}}{\text{Estimated Useful Life}} = \frac{\$6{,}520 - 0}{5} = \$1{,}304/12 \text{ months} = \$108.67$$

The annual depreciation of the equipment is $1,304. Suppose Justin has had the equipment in his business for only three months and wishes to take three months' worth of depreciation. He would multiply the monthly amount, or $108.67, by three months, for total depreciation of $326.01.

The adjusting entry required is as follows:

522	Depreciation Expense	Dr.	$326.01
156	Depreciation—Computer Equipment	Cr.	$326.01

The steps followed to enter this adjustment in the worksheet are as follows and are shown in Figure 7.9:

1. The account Depreciation Expense (#522) is not listed in the Account Titles column, so you need to add the name below the last entry in the Account Titles column.
2. Enter the amount of depreciation expense ($326.01) as a debit in the Adjustments column. Place the letter (c) next to the entry.
3. The contra-asset account Depreciation—Computer Equipment (#156) is not listed in the Account Titles column, so it also must be added. Add this below the account Depreciation Expense (#522). Enter $326.01 as a credit in the Adjustments column and place the letter (c) next to the entry.
4. Calculate the new account balances after making the adjustments. The adjusted balance for Depreciation—Computer Equipment (#156) is $326.01, and for Depreciation Expense (#522) is $326.01.
5. Note that the account Computer Equipment (Hardware) (#155) has not been changed. The value of this account has remained at $6,520, its historical value.

Adjustment d: Personal Loan

Justin paid $1,000 to his father on the loan he accepted, but $100 of that was interest. His records show that he owes his father $3,000, but in fact he owes his father $3,100 because the $100 for interest did not reduce the principal amount owing. Justin should have recorded the payment as a debit to Interest Expense (#529) of $100 and $900 to the Personal Loan liability account (#205). Because Justin's books show the amount of the loan outstanding at $3,000, he must correct this entry. He can do this using the following adjusting entry:

529	Interest Expense	Dr.	$100
205	Personal Loan	Cr.	$100

The steps required to enter this adjustment in the worksheet are as follows and are shown in Figure 7.9:

1. The account Interest Expense (#529) is not listed in the Account Titles column, so you have to add the name below the last entry in the column.
2. Enter the amount of interest expense of $100 as a debit in the Adjustments column. Place the letter (d) next to the entry.
3. The personal loan secured by Justin was recorded in the account Personal Loan (#205) in the liabilities section of the balance sheet. This account is listed on the trial balance, so the amount of $100 can be entered as a credit in the Adjustments column. Place the letter (d) next to the entry.
4. Calculate the new account balances after making the adjustments. The adjusted balance for Personal Loan (#205) is $3,100, and Interest Expense (#529) has a debit balance of $100. These amounts are shown in the Adjusted Trial Balance column.

Adjustment e: Accrued Salaries Expense

Justin has an employee who works five days a week, from Monday to Friday, and receives $80 a day or $400 a week. She gets paid every two weeks on Friday. She was paid on the 12th and 26th of December and will receive her next paycheque on the next payday, which is January 9, next year. However, at the end of the fiscal period, December 31, the employee is owed three days' pay for December 29, 30, and 31. This payment will be made on January 9. An adjusting entry is therefore required to reflect the **accrued salaries expense** payable for three days at the rate of $80 a day for a total of $240. This can be done using the following adjusting entry:

511	Salaries Expense	Dr.	$240
220	Accrued Salaries Payable	Cr.	$240

The steps required to enter this adjustment in the worksheet are as follows and are shown in Figure 7.9:

1. The account Salaries Expense (#511) is already listed in the Account Titles column. Debit the Adjustments column $240 to show the expense for salaries, and place the letter (e) in the box next to the entry.
2. Accrued Salaries Payable (#220) is not listed in the Account Titles column and must be added at the end.
3. Enter the amount of accrued salaries payable of $240 as a credit in the Adjustments column. Place the letter (e) in the box next to the entry.
4. Calculate the new account balances after making the adjustments. The adjusted balance for Salaries Expense (#511) will be $1,200, and Accrued Salaries Payable (#220) will have a credit balance of $240. These amounts are shown in the Adjusted Trial Balance column.

Checking the Adjusting Entries

To ensure that no mistakes were made in entering the adjusting entries, total the debit and credit columns of the Adjustments column in the worksheet (see Figure 7.9). The total debits must equal the total credits. If the totals are not equal, you should stop and look for errors using the same strategies for finding errors that were explained in Chapter 4. Do not proceed until these columns are balanced.

Adjusted Trial Balance Column

All account balances from the trial balance must be extended to the Adjusted Trial Balance column (see Figure 7.9). If you did not already calculate the balances across the accounts as you prepared the adjustments, you may do so at this point. Many people prefer to wait until all the adjustments are completed before calculating the adjusted trial balance. Remember to add debits together and to add credits together. Take the difference when calculating debits plus or minus credits and make sure you enter the result in the correct column. Keep in mind what the normal balance is supposed to be for each category of account (see Chapter 3):

Side of the account used to record an increase to the normal balance

Accounts with a normal debit balance + = Dr.

Debit	**C**redit
Expenses	**L**iabilities
Assets	**I**ncome (fees)
Drawings	**C**apital
DEAD	**CLIC**

Accounts with a normal credit balance + = Cr.

If the balance is not the normal balance associated with that category of account, ask yourself: "why not?"

Looking for Errors

Consider the following possible causes of errors:

- Calculation error: Two debits were not added together, and instead were subtracted from one another or vice versa.
- Calculation error: You did not subtract debits and credits.
- Entry in wrong column: The entry was put in the debit column instead of the credit column or vice versa.
- You did not carry over the balances from the trial balances for the accounts that had no adjustment.

Once the debit and credit columns in the adjusted trial balance are equal, you are ready to move on to preparation of the financial statements.

Income Statement and Balance Sheet Columns

The totals from the adjusted trial balance should be carried over to the Income Statement column or the Balance Sheet column, depending on the category of account. Figure 7.8 shows the balances once they have been extended. Copy the amounts one by one from the adjusted trial balance over to the correct statement. Remember that the accounts numbered 100 to 399 belong in the Balance Sheet column and should be extended to the respective debit or credit columns. The accounts numbered 400 to 599 belong in the Income Statement column, so these amounts should be extended to the respective debit or credit columns.

Take care not to include the asset accounts listed at the bottom of the worksheet in the wrong category or statement. Pay particular attention to the contra-asset account for accumulated depreciation and the salaries payable account. These are credit balances that belong on the balance sheet.

Completing the Worksheet

Total the debit and credit columns of the Income Statement and Balance Sheet columns of the worksheet. Your next task is to balance the Income Statement and Balance Sheet columns.

Calculating Net Profit or Loss

Figure 7.8 shows the following steps (in superscript) in calculating the net profit or net loss:

Justin Case, Paralegal Worksheet for the Month Ended December 31, 20**				
	Income Statement		*Balance Sheet*	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	Totals	Totals	Totals	Totals
Totals	[1]5,959.10	[1]31,580.00	[5]56,506.91	[5]30,886.01
[4]Net Profit	[2]25,620.90			[6]25,620.90
	[3]31,580.00	[3]31,580.00	[7]56,506.91	[7]56,506.91 [8]

FIGURE 7.8 Completing the bottom portion of the worksheet

1. Total the Dr. and Cr. columns in the income statement section. They will not be equal.
2. Subtract the total credits and debits. If your credits on the income statement are higher than the debits, you have a net profit, but if the debits are higher than the credits, you have a net loss. Enter this figure in the space below whichever column has the smaller total.
3. Add the numbers at the bottom of the columns. The total debits should now equal the total credits at the bottom of the Income Statement column.
4. Write "Net Profit" or "Net Loss" in the Account Titles column.

Completing the Balance Sheet Portion of the Worksheet

5. Total the Dr. and Cr. columns in the balance sheet portion of the worksheet. They will not be equal.
6. Place the amount of the net profit or loss from step 2 in the space below whichever column has the smaller total.
7. Add the balance sheet debit and credit columns on the last line of the worksheet. The debit and credit columns must be equal.
8. Rule the columns by placing a single line above and a double line below the totals.

A completed worksheet with all the adjustments and balances extended is shown in Figure 7.9.

Once you have calculated the net profit or loss and used the result to balance the columns under the balance sheet heading, you have the information you need to prepare financial statements for the firm.

Justin Case, Paralegal
Worksheet
for the Month Ended December 31, 20**

		Trial Balance		*Adjustments*				*Adjusted Trial Balance*		*Income Statement*		*Balance Sheet*	
	Account Titles	*Dr.*	*Cr.*		*Dr.*		*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
100	General Bank Account	4,906.91						4,906.91				4,906.91	
115	Trust Bank Account	15,280.00						15,280.00				15,280.00	
120	Accounts Receivable	25,000.00						25,000.00				25,000.00	
125	Prepaid Insurance	600.00				a	50.00	550.00				550.00	
130	Office Supplies	630.00				b	430.00	200.00				200.00	
155	Computer Equipment (Hardware)	6,520.00						6,520.00				6,520.00	
158	Office Furniture and Equipment	2,250.00						2,250.00				2,250.00	
200	Accounts Payable/ General Liabilities		6,890.00						6,890.00				6,890.00
205	Personal Loan		3,000.00			d	100.00		3,100.00				3,100.00
210	Credit Card Debt		2,500.00						2,500.00				2,500.00
215	Trust Funds Owed		15,280.00						15,280.00				15,280.00
300	Justin Case, Capital		2,550.00						2,550.00				2,550.00
350	Justin Case, Drawings	1,800.00						1,800.00				1,800.00	
400	Fees Earned		31,580.00						31,580.00		31,580.00		
511	Salaries Expense	960.00		e	240.00			1,200.00		1,200.00			

		Trial Balance		Adjustments				Adjusted Trial Balance		Income Statement		Balance Sheet	
	Account Titles	Dr.	Cr.		Dr.		Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
533	Meals and Entertainment Expense	350.00						350.00		350.00			
534	Membership/ Professional Dues	1,343.75						1,343.75		1,343.75			
535	Office Supplies/General Expense	580.00		b	430.00			1,010.00		1,010.00			
538	Rent Expense	1,100.00						1,100.00		1,100.00			
565	Telephone Expense	479.34						479.34		479.34			
	Total	61,800.00	61,800.00										
527	Insurance Expense			a	50.00			50.00		50.00			
522	Depreciation Expense			c	326.01			326.01		326.01			
156	Depreciation—Computer Equipment					c	326.01		326.01				326.01
529	Interest Expense			d	100.00			100.00		100.00			
220	Accrued Salaries Payable					e	240.00		240.00				240.00
	Totals				1,146.01		1,146.01	62,466.01	62,466.01	5,959.10	31,580.00	56,506.91	30,886.01
	Net Profit									25,620.90			25,620.90
	Totals									31,580.00	31,580.00	56,506.91	56,506.91

FIGURE 7.9 Completed worksheet

CHAPTER SUMMARY

The accrual basis of accounting requires that financial statements reflect revenues when earned and expenses when incurred so that they are reported in the correct accounting period. The adjustment process enables the record-keeper to adjust account balances to ensure that what is reported in the financial statements accurately reflects the financial position of the firm. A paralegal wishing to know how his or her business is doing will want to prepare an income statement fairly frequently. This practice tells the owner whether the company is making or losing money. The balance in the bank account is not always an indication of how your business is doing. The bank balance may show income from various sources, such as an investment by the owner, a transfer from the line of credit, or revenue earned.

Remember that a paralegal working as a sole proprietor does not receive a salary. Money is taken out of the firm by way of drawings. The income statement and balance sheet will tell the owner whether or not there is a profit from which a draw can be taken. Recording amortization on assets and preparing the common adjustments help to ensure that the financial records of the firm accurately reflect its financial position.

KEY TERMS

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FURTHER READING

Canada Revenue Agency, "Accounting Methods," online: <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/ccntng-eng.html>.

Canada Revenue Agency, "Claiming Capital Cost Allowance (CCA)," online: <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/menu-eng.html>.

Canada Revenue Agency, Guide T4002(E), "Business and Professional Income," online: <http://www.cra-arc.gc.ca/E/pub/tg/t4002/t4002-14e.pdf>.

Canada Revenue Agency, "Information for Canadian Small Businesses," RC4070, online: <http://www.cra-arc.gc.ca/E/pub/tg/rc4070/rc4070-14e.pdf>. See especially Chapter Six: Income Tax.

Canada Revenue Agency, "Small Businesses and Self-Employed," online: <http://www.cra-arc.gc.ca/selfemployed>. Topics of interest: capital cost allowance, WIP, accruals.

Michael Cooke, "2014-0531461E5 E—Paralegals and Work in Progress Election," 28 May 2014, online: <http://taxinterpretations.com/?p=27323>.

PUT IT INTO PRACTICE

Case Example: Financial Statements

Ann Litigate has scheduled a meeting with her small-business bank manager to discuss getting an additional line of credit. However, the bank manager has concerns about Ann's current debt ratio because this would be an additional credit facility. She has asked Ann to provide her with an interim financial statement. Ann does not understand why the bank manager needs this information because the bank produces statements for her general bank account and trust account each month. She thought that these bank statements, together with last year's tax return and financial statement, would be sufficient. Also, Ann does not know what information to provide to her accountant to prepare the interim financial statement, because she tends to contact the accountant only at the end of the year when she does her tax reporting.

1. Why would the bank manager need to see an interim, year-to-date financial statement as part of the bank approval process?
2. What are some of the things that Ann will need to discuss with her accountant? Which items on the balance sheet or income statement will likely require an adjustment? (Hint: Assess the before-adjustment and after-adjustment journal entries that may be required for such items on the balance sheet or income statement.)
3. What records will Ann need to review and update so that the accountant is in a good position to prepare the financial statement?

REVIEW QUESTIONS

True or False

_____ 1. The worksheet is an example of a financial statement.

_____ 2. A contra-asset account reduces the value of an asset.

_____ 3. An accrual is an adjustment that recognizes when cash is received or used to make a payment.

_____ 4. Each entry on the adjusted trial balance represents an account that has been adjusted.

_____ 5. The debit (Dr.) and credit (Cr.) entries in the Balance Sheet portion of the worksheet are equal.

_____ 6. Book value means the same thing as fair market value.

_____ 7. Prepaid expense is an asset account reflected on the balance sheet.

_____ 8. Paralegals can elect to exclude WIP in reporting income at the end of the financial year.

_____ 9. Capital cost allowance is a tax reporting term used in the calculation of depreciating assets.

_____ 10. Accumulated depreciation has a normal credit balance (Cr.).

Short Answer

1. When Ann Litigate purchased $1,000 worth of stationery and supplies for the office, she recorded the purchases in the asset account Office Supplies (#130). At the end of the year, she calculated the value of her office supply stock as $350.
   a. What must Ann do to correctly reflect the accrued assets and expenses over the course of the past three months?
   b. Calculate the value of the office supplies used during the period.
   c. Which accounts need to be adjusted to record the office supplies used?
   d. If Ann does not make the necessary adjustment to her books, which account will be overstated and which will be understated?
   e. How would failure to make the adjustment affect
      i. the income statement?
      ii. the balance sheet?
2. What is the relationship between the adjusted trial balance and the income statement, balance sheet, and statement of owner's equity?

PRACTICE EXERCISES

Practice Exercise 7.1

Complete the following table by calculating depreciation using the straight-line method for five years.

PRACTICE | EXCEL

Calculation of depreciation using the straight-line method							
Office Equipment	Life	Historical Cost	Residual Value	Year	Depreciation 3,500/10 yrs.	Accumulated Depreciation	Book Value
Computers	10	4,000	500	1	350	350	3,650
				2	350	700	3,300
				3			
				4			
				5			

Practice Exercise 7.2

Complete the following table by calculating amortization using the declining balance method.

Calculation of amortization using the declining balance method						
Item	Class	%	Year	Cost	CCA	UCC
Computer	10	30%	1	5,000.00	750.00*	4,250.00
UCC x 30%			2		1,275.00	2,975.00
			3			
			4			
			5			
Total CCA						

* Note: Only half of depreciation allowed was taken in year 1.

Practice Exercise 7.3

Using the worksheet provided, prepare the adjusting entries for Ann Litigate's financial records, which her accountant will use in preparing her year-end financial statements.

a. Dec. 31: Payment on account received (invoice #xx501, M. Arbor), $1,000.

b. Dec. 31: Prepaid professional insurance used up, $2,500 (one-year policy, from February of this year until February of next year, valued at $3,000).

c. Dec. 31: Rent expense recognized (Magnum Office Managers), $1,200.

d. Dec. 31: Office supplies used up, $200.

e. Dec. 31: Depreciation of computer equipment, $1,360/year based on the declining balance amortization calculation. Assume that Ann purchased the computer equipment for $6,800 in the previous year and that the annual depreciation being claimed is 20 percent.

PRACTICE EXCEL

Ann Litigate, Paralegal
Worksheet
for the Month Ended December 31, 20**

	Account Titles	Trial Balance		Adjustments				Adjusted Trial Balance	
		Dr.	Cr.		Dr.		Cr.	Dr.	Cr.
100	General Bank Account	15,360							
115	Trust Bank Account	18,500							
120	Accounts Receivable	3,500							
125	Prepaid Insurance	3,000							
128	Prepaid Expense (Rent)	1,200							
130	Office Supplies	800							
155	Computer Equipment (Hardware)	6,800							
156	Depreciation—Computer Equipment								
200	Accounts Payable/General Liabilities		6,500						
210	Credit Card Debt		4,500						
215	Trust Funds Owed		18,500						
300	A. Litigate, Capital		12,500						
350	A. Litigate, Drawings	2,000							
400	Fees Earned		10,550						
511	Salaries Expense	1,000							
522	Depreciation Expense								
527	Insurance—Professional Liability								
534	Membership/Professional Dues	230							
535	Office Supplies/General Expense								
538	Rent Expense								
565	Telephone Expense	160							
	Totals	52,550	52,550						

PRACTICE

EXCEL

Practice Exercise 7.4

Prepare the income statement and balance sheet portion of the worksheet from the adjusted trial balance for Ann Litigate's firm.

Ann Litigate, Paralegal Worksheet for the Month Ended December 31, 20**								
	Account Titles	Adjusted Trial Balance		Income Statement		Balance Sheet		
		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
100	General Bank Account	16,360					
115	Trust Bank Account	18,500					
120	Accounts Receivable	2,500					
125	Prepaid Insurance	500					
128	Prepaid Expense (Rent)	0					
130	Office Supplies	600					
155	Computer Equipment (Hardware)	6,800					
156	Depreciation—Computer Equipment		1,360				
200	Accounts Payable/General Liabilities		6,500				
210	Credit Card Debt		4,500				
215	Trust Funds Owed		18,500				
300	A. Litigate, Capital		12,500				
310	A. Litigate, Withdrawals	2,000					
400	Fees Earned		10,550				
511	Salaries Expense	1,000					
522	Depreciation Expense	1,360					
527	Insurance—Professional Liability	2,500					
534	Membership/Professional Dues	230					
535	Office Supplies/General Expense	200					
538	Rent Expense	1,200					
565	Telephone Expense	160					
	Totals	53,910	53,910				
	Net Profit						

Practice Exercise 7.5

Prepare the following adjusting entries for Peter Bitter's Legal Services firm and complete all columns of the worksheet.

a. An adjustment for office supplies is required. The ending inventory as of December 31 is $300. Expense the office supplies used up over the period.

b. The landlord required prepayment of rent when Peter's firm moved into the premises. The amount of $1,200 has now been used up and needs to be written off as an expense.

c. At year-end, the firm owes three days' salary to the assistant at the rate of $90 per day.

d. The firm is taking $300 depreciation on office furniture and equipment.

PRACTICE

EXCEL

Peter Bitter's Legal Services
Worksheet
for the Month Ended December 31, 20**

	Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
100	General Bank Account	5,230									
115	Trust Bank Account	3,200									
120	Accounts Receivable	3,500									
128	Prepaid Expense (Rent)	3,000									
130	Office Supplies	1,200									
158	Office Furniture and Equipment	22,000									
159	Dep. Office Furniture and Equipment		600								
200	Accounts Payable/General Liabilities		6,500								
215	Trust Funds Owed		3,200								
220	Accrued Salaries Payable										
300	Peter Bitters, Capital		13,170								
350	Peter Bitters, Drawings	6,000									
400	Fees Earned		29,000								
511	Salaries Expense	4,000									
522	Depreciation Expense	250									
527	Insurance—Professional Liability	450									
534	Membership/Professional Dues	230									
535	Office Supplies/General Expense	250									
538	Rent Expense	3,000									
565	Telephone Expense	160									
	Totals	52,470	52,470								
	Net Profit										